

# How to Read an Annual Report

By **STUART CHASE**

To many lay people, the understanding of a financial report of a corporation is seemingly beyond the realm of possibility. However, as Mr. Chase explains, the modern financial report contains a wealth of information with which an informed stockholder or potential stockholder should be familiar. The author points out the facts such a stockholder ought to want to see in the annual report of his corporation. This article is reprinted from *The Lamp* for Winter, 1957-1958, the beautifully illustrated publication of Standard Oil Company of New Jersey.

**Y**OU slit the envelope and out comes the financial report, dripping figures. It looks most impressive, but what has it got to tell you?

Well, what do you want to know? What are the important questions you would like to have answered?

In this article we will think primarily of a small stockholder. We will call him George Rutherford Adams of Middleburg, Connecticut, who runs a garage, service station and sandwich bar. He was wounded in North Africa, has a wife and three children, and hopes with all his heart that there will never be another war or another bad depression like the 1930's. His cash income last year was \$5,900, and he has 20 shares of stock in the Excelsior Refining Company, bought with his veteran's bonus. Excelsior is one of the larger oil companies, with its stock listed on the Exchange.

We shall try to look inside George's mind and find out what he wants to know about the Excelsior Refining Company or any other company in which he happens to own a few shares of stock.

We know right off the bat he does *not* want to grope his way through a forest of figures. In that respect he is like a lot of Americans.

As a small stockholder, the two main things George would like to know are these: how much better off he is personally as a result of the company's operations, and

how long this happy condition can be expected to last—in other words, how strong is the outfit. We are not only going to try to find out what he wants to see, but what he *ought to want* to see in a modern financial report.

## Ten Top Questions

Suppose we begin by putting down the leading questions to which most people want answers in a financial statement.

The top questions that ordinary or garden-variety stockholders might ask are the following—and incidentally, these are the questions that interest me, as a small stockholder in various companies, as an occasional investor, as an economist and as an accountant.

(1) **What did the company earn?** This figure has a direct effect on George's income, because it indicates possible dividends on his stock. But it does not indicate, except in a very general way, the value of George's 20 shares over the years or what they may be worth in the future. More background figures are necessary for this long view. Also, George and I want some *comparisons*. What were the earnings the year before and the earnings for the past five years? What did they amount to per share, again with comparisons? (Other important questions about earnings will be saved for the section on the income statement.)

(2) **What dividends did the company pay?** This is getting right into George's family

Mr. Chase began his working life in Boston as a CPA. Later he turned to economic research and then to writing. He is well known for his works on social problems (such as *Tyranny of Words*) and economics. He has also prepared material for the Twentieth Century Fund and has served on various government and United Nations commissions.

budget, but again it does not tell us much about the company. Anyone who can scare up some credit can pay dividends—while the credit lasts. The real question is whether George has his money in what looks like a permanent dividend machine. We want to know, George and I, about dividends per share compared with other years, and especially we want to know what happened to the earnings *not* paid out in dividends. It is really our money, and where is it? Maybe we should not have got it all in dividends, but we like to know *why* we shouldn't. The financial report that dodges this question—and many of them do—does not come clean.

(3) **What does the company own, and what does it owe?** What is left for the stockholders? This is the distilled essence of the company's balance sheet. It tells George how strong his company is, how far away from insolvency. We will come back to it in a moment.

(4) **How big is the company?** Is it a billion dollar baby; is it one of the blue chips? The best answer to that is the "total assets" figure on the balance sheet. We want to know, George and I, what the position of our company is in the general scheme of things, its place in the industry and in the nation.

(5) **How many people work for the company?** This is another angle on size and immediately makes the company seem more human. You see the people coming in buses and cars to work in the morning—people like the rest of us. They are the real company—they make it go, managers and men together. Few financial reports showed this figure in the past, but now more are beginning to show it. It is an important figure. A note on labor policy is also welcome. Earnings tend to vary inversely with strikes.

(6) **What are the total sales or revenues?**

This figure gives a third angle on the company's size. It shows the total dollars flowing in from customers, the lifeblood of the financial structure. How does the year just passed compare with the year before, with the average of the past five years? Total sales for one year mean little. Only comparisons with other years, as in the case of income, tell a real story. Are we going up or are we going down? What is the effect of inflation? The last question can be answered by showing barrels of oil beside the dollar figures. If the sales in dollars are going up, and the sales in barrels are going down, beware! Inflation is distorting the picture.

(7) **What service to the community does the company render?** Is it a manufacturing company, a trading company, a financial company, a utility company? Does it make shoes, or operate chain stores, or provide banking facilities, or produce movies, or refine oil? How many pairs of shoes does it make; how many depositors has it; how many stores? Such figures are also beginning to appear on the reports. They give George Adams a sense of reality. His company does not make only dollars. It makes gasoline, or men's suits—something tangible and important.

(8) **Where are the company plants?** This helps to give reality, too. A map may be useful to show where the factories, refineries, selling outlets or railroad lines are located. Ever since World War II, a very important question deals with property owned abroad. Is it in a danger zone—in Egypt, say, or Indonesia? If a large share of the company's assets are in such places, what steps has the company taken to set up reserves against possible loss?

(9) **Where do the company's raw materials come from?** If the company manufactures shoes or produces petroleum, it is important to know what the outlook is for hides or for new oil fields. Everything might have been wonderful last year, but how about the outlook for years hence? What is the considered opinion of management about that?

(10) **Who audited the figures?** As a CPA, I usually look first at the accountant's certification. If it is a reliable firm and the certificate does not contain too many important exceptions, I know that I can put a lot of confidence in the figures. I know they have not been slanted, and that nothing has been covered up so far as the

official records go. George ought to learn to look for the certificate, too; it is something like the sterling mark on silver.

**Summary.**—If the annual report of the Excelsior Refining Company, as it falls out of the envelope—whether in four colors or on plain butcher paper—carries clear answers to these ten questions, George Adams will probably find all he wants to know about his company and then some. Observe that he will learn:

Whether the company is on the way up or on the way down in earnings and sales.

The outlook for future earnings, based on trends, labor policy, raw materials, foreign business, etc.

How dividends compare with interest on his government bonds, with his money in the savings bank and income from his own garage business.

The size of his company—thus making him feel big and important, too. "I own this billion dollar outfit, at least a piece of it!"

In brief, George should be able to tell pretty well whether or not his investment is safe, whether there is a ready market for his shares of stock and whether he will receive a fair return on his money.

### Double-Entry Bookkeeping

However simple the statements may be in the first pages of the annual report, if a CPA is going to certify to them they must be drawn directly from the official books and must reconcile with the records of hawk-eyed income tax examiners. The United States Government is now the silent partner of every American corporation, in most cases taking more than 50 per cent of the taxable income. This is a hard fact, which it does no good to overlook and which is unlikely to change much so long as the cold war lasts.

We can dress up the wording of the annual report as prettily as we please, but the figures must reconcile with the accounting records and with the federal income tax report, and they must be acceptable to the CPA. Back in the 1880's, a corporation could get away with murder in reporting to the stockholders, but with these modern checks and balances, George can relax a little as he reads.

Double-entry bookkeeping was invented by the Italians more than 500 years ago. It is as important a social invention as constitutional government or habeas corpus.

It specifies that for every debit there must be a corresponding credit. A simple illustration is that when you buy a share of stock your "cash" goes down (a credit on your books), and your "investments" go up (a debit on your books).

This is the reason why the assets on the balance sheet should equal the liabilities and net worth, to the penny. The sum of the debits must equal the sum of the credits. Under the principles of double-entry bookkeeping, this is mandatory. If they are as much as four cents out, the auditor and the accounting department tear their hair, lock the doors, run up prodigious bills for heat and light until the four cents is found. Double-entry bookkeeping, now practiced by every firm of any size, is in itself a kind of preliminary audit—something for the small stockholder to be pleased about.

### Income Statement

So much for introductory remarks. Now we come to the hard core of the financial figures, the income statement and the balance sheet. These are drawn right from the official accounting records.

We will look first at the income statement, which is the more important today. It tells the dynamic story of how things are *moving*. The balance sheet, on the other hand, tells the static story of how things *stand* on a given date. There is more news value in how things move than in how things stand. In some annual reports, the balance sheet is called the "statement of financial position."

The income statement shows the rate of production, energy consumed, stuff turned out—dynamic happenings. The balance sheet shows solvency, cash on hand, goods on the shelves, values of land, buildings, machines—all important, but without blood and sweat, without conveyor belts, smoking chimneys, clanging freight cars. It shows the company frozen for an instant, at the year's end.

In its simplest form the income statement is composed of three figures. They are always the *first* figures for George to size up, no matter how complicated the statement. Here they are, in round numbers for illustration:

Total sales or revenues.....	\$1,000,000
Total costs and expenses.....	900,000
Net earnings for the year.....	\$ 100,000

You do not have to be a mathematical wizard to see immediately that the company is making 10 per cent on its sales. This looks like a roomy margin, but other comparisons must be made before you can be sure. How about the year before and an average, say, for the last five years? What do other companies make in the same line of business? If five such companies are averaging 20 cents per dollar of sales last year, our company is not so hot as we thought it was. But if they are averaging only five cents, then we are hot indeed—at least we were *last year*.

A financial report that carries no comparisons at all, just the current figures, is almost meaningless to the wayfaring reader. Without some other years or other companies to train his sights on, he learns very little.

The above three figures, with the indicated comparisons, may be enough for George Rutherford Adams. They give him the line he wants on the company. But other stockholders and investors may want to go further. From now on, it becomes a case of breaking down the details of the income statement, which may fan out to any layer of complexity. The next layer below is the one I usually want to look at, unless I am making a very intensive analysis. It lines up something like this (the figures, again, are purely illustrative):

Total sales or revenues.....	\$1,000,000
Wage and salaries.....	\$400,000
Materials used .....	300,000
Overhead expense ....	100,000
Total costs .....	800,000
Net earnings before federal income tax .....	\$ 200,000
Tax .....	100,000
Net earnings for year.....	\$ 100,000
Dividends paid .....	60,000
Reserved for use in or expansion of the business.....	\$ 40,000

This tells us what the employees are getting, the size of the raw materials bill, the ratio of overhead expense to direct costs. It tells us what the earnings were before Uncle Sam took a slice from the pie. I cannot get a real line on performance when earnings are shown only *after* taxes. Most of us who go this far would like to see also the following, with comparisons with other years: percentage of earnings to net worth; earnings per share of stock; dividends paid per share of stock.

The first is a very important figure, more important than percentage of earnings to sales, for it tells how much is being earned on the stockholders' total investment. "Net worth" includes whatever value is placed on "capital stock" in the balance sheet, plus "surplus." Another name for surplus is "earnings reinvested in the business." Another name for net worth is "stockholders' equity." The percentage of earnings to net worth can be compared with *any* company in *any* line of business, while the percentage on sales can only be compared with companies in the *same* line of business. When inflation is active, the former percentage is somewhat less reliable, but it remains the best standard for comparison between industries.

Another way to define net worth is this: Take what the company owns, as shown on the balance sheet. Deduct what it owes to outsiders, including bondholders. What is left should belong free and clear to the stockholders, their equity in the business.

## Depreciation

Suppose we go down another layer on the income statement. "Sales" will then fan out into various types. Wages, materials, overhead expenses will fan out to give more detail. We shall also find on this level a hefty figure in the overhead division labeled "depreciation." This term is what turns the hair of federal income tax examiners white, and keeps half the accountants of the republic in business.

When accounting was just beginning to be a profession, along about 1900, allowances for depreciation were strictly free style—charge off \$1 million against earnings in a good year, and forget it in a bad year. My father, I am proud to say, was one of a small and scrappy band of pioneers who fought this procedure and finally eliminated it. They point out that punch presses, brick walls, cast iron pipes and office furniture were gradually wearing out, regardless of good years or bad years. No matter how often they were patched up and repaired, the day would come when they would have to be junked. Where was the money to replace them?

Many a business in those days suddenly found itself in financial difficulties, if not in bankruptcy, because it forgot all about the remorseless and *regular* processes of wear and tear on company property. The band of fighters to which my father belonged insisted that the books show this property loss, and show it with unflinching regularity in good years and bad alike.

They won their fight, to all intents and purposes, when periodic allowances for depreciation were incorporated into the federal income tax rules.

This was fine in theory, but how much in dollars and cents does the property wear away each year—is it 2 per cent or 10 per cent or 25 percent? The headaches and nervous breakdowns come in here. What the company comptroller is trying to do is to set aside from earnings an equitable proportion of the cost of buildings or machinery over their useful life. This helps to provide a fund with which to replace such facilities when they wear out. Depreciation is not an easy thing to estimate, and when inflation comes along it makes the headache much worse, because there may not be enough in the reserve fund to buy the new machine.

But as small stockholders, George and I can rest fairly easy in the knowledge that no company bookkeeper can play fast and loose with depreciation charges these days. There are two grim watchdogs perpetually on his trail—the outside accountant and the United States Treasury.

This also goes for the allied accounts of “depletion” and “obsolescence.” The first seeks to measure the coal taken out of the mine toward the day when there will be no more coal—or copper or iron or oil—left underground in that location. The second seeks to measure when that piece of machinery, while it may be still in good working order, will have to be scrapped because a new model can do the job better. The easiest way to grasp the obsolescence idea is to think of a woman’s hat—intact but unwearable next year!

So we can go down the income statement, layer below layer, until every original voucher of revenue or expenditure is laid bare.

## Balance Sheet or Statement of Financial Position

The balance sheet is the final expression of double-entry bookkeeping and the end result of all accounting records. But as presented in most reports, it gives George the blind staggers. Here on the left-hand side it says “assets”; on the right-hand side it says “liabilities.” You look down at the bottom and the figures agree to the penny. So the liabilities are equal to the assets, and George thinks the company must be on the edge of bankruptcy.

The liabilities do *not* equal the assets, but the ordinary balance sheet certainly

reads that way. There are two methods for clearing this up in the annual report. As in the case of the income statement, the big news consists of three figures. The first way to show them is in two columns:

### Left-hand column

Total assets .....	\$1,000,000
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### Right-hand column

Total liabilities .....	\$ 600,000
Net worth .....	400,000

Total liabilities and net worth	\$1,000,000
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The second way is in a single column:

Total assets .....	\$1,000,000
Less liabilities .....	600,000

Net worth belonging to stockholders .....	\$ 400,000
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The first way retains the classic balance sheet form, right and left, with totals in agreement. My father used to insist that all reports leaving his office should be headed on the right-hand side in large capital letters: LIABILITIES AND NET WORTH. This made it clear that it was two utterly different classes whose sum equaled the ASSETS.

Personally I prefer the second way. Here is what the company owns; deduct what the company owes and net worth remains, as we noted earlier.

A variation on the second way shows a little more detail, like this:

Current assets .....	\$350,000
Less current liabilities .....	175,000

Working capital .....	\$175,000
Add other assets .....	650,000

Total .....	\$825,000
Less other liabilities .....	425,000

Net worth, or stockholders' equity ..	\$400,000
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The *ratio* of total liabilities to total assets is also a timely figure. The lower the ratio, the sounder the company, generally speaking. In the above case the ratio is 60 per cent. A comparison with last year is also helpful. Has the liability ratio gone up significantly? Why?

That “why” calls for further explanation, and perhaps we can get it by going down another layer on the balance sheet—just as we went down on the income statement. It ought to look something like the balance sheet that appears on the following page.

Here we have the chief balance sheet items. If trouble does not show up here,

## BALANCE SHEET (End of Year)

Assets		Liabilities and Net Worth	
Cash .....	\$ 50,000	Bank loans .....	\$ 100,000
Inventories .....	200,000	Other current liabilities .....	75,000
Other current assets .....	100,000		
	<hr/>	Total current liabilities .....	\$ 175,000
Total current assets .....	\$ 350,000	Bonds outstanding .....	300,000
Investment in other companies ..	100,000	Reserves for contingencies .....	125,000
Plant and equipment (less depreciation) .....	400,000		
Deferred charges .....	10,000	Total liabilities .....	\$ 600,000
Patents, good will, etc. ....	140,000		
	<hr/>	Capital stock .....	300,000
Total assets .....	\$1,000,000	Surplus (earnings reinvested in the business) .....	100,000
			<hr/>
		Total net worth .....	\$ 400,000
			<hr/>
		Total liabilities and net worth ..	\$1,000,000

it is not likely to be very bad trouble. What are the things to look for? There are a number of them, and suppose we take them briefly in order:

**Inventories.**—How has the merchandise on hand been priced? One rule is “cost or market price, whichever is the lower.” Another rule is nicknamed “LIFO,” meaning those items “last in, first out.” Today, with price inflation interrupted by some severe price collapses in various commodities, it is especially urgent to know if the inventory figures have been safeguarded. Also, what was the comparable figure last year? In my opinion, the report should state plainly how inventories have been priced.

**Total current assets.**—These should immediately be compared with current liabilities, and a ratio established. In this case it is 2.0—current assets are twice liabilities. What is the usual ratio for companies in this line of business? If the ratio appears out of line, George should be interested and seek an explanation from his company.

**Investments.**—This brings up the important question of whether this is a “consolidated” balance sheet. If it is, it should be clearly identified, and we should know how investments are carried or how they have been evaluated.

A consolidated balance sheet is a statistical roundup of figures intended to show the financial position of an entire family of consolidated companies at a given date. The assets and liabilities of the various companies are fanned out through the bal-

ance sheet. The excess of these assets over liabilities is again net worth, or stockholders’ equity, for all companies. Such a consolidation gives George a good estimate of the value of his investment if his 20 shares are in a parent company.

Investments in marketable and other securities (in unconsolidated companies, for example), are normally carried on the balance sheet at cost, and this should be explained in the balance sheet itself or in the accompanying explanatory notes.

**Plant and equipment.**—In the old days before the income tax, the sky was often the limit for this account. It was written way up or written way down, and far from a true figure. Tax regulations have brought about a considerable improvement in plant accounting methods, and since the Treasury boys got on the job checking depreciation, George and I can be reasonably sure that the figure now makes sense.

**Patents and good will.**—“Deferred charges,” meaning mostly bills the company has paid in advance, we can skip, but the “patents and good will” account is significant. It may be the corporation waste basket, full of tin cans, broken bottles and old wrapping papers. If the figure is relatively large—as it is in the above balance sheet (\$140,000)—we had better go down some more layers to reach the bottom of it.

In the dear, dead days beyond recall, farmers driving cattle to market used to halt outside the town, give the critters a round of salt and then let them drink their heads off. This raised the weight and the

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his wife for which notices of liens were filed. He failed to recover these taxes since it was held that he voluntarily paid them although he was not legally obligated to do so.

In *Fecarotta v. U. S.*, 56-2 USTC ¶9691, under distraint proceedings a wife obtained a certificate of discharge from a lien upon the payment of taxes claimed to be owing

for 1947 and 1948 by her deceased husband. She married her husband on December 2, 1948, and held the property in joint tenancy upon its acquisition by them in 1949. The court permitted the wife to recover the amount of the taxes paid, holding that her payment was not voluntary and that she was not estopped to assert her claim.

[The End]

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total price. Thus was "stock watered." Presently the phrase was applied to financial deals where assets were pumped full of dubious liquids and gases, especially in the good will account. Normally "good will" means something of value but hard to estimate in dollars—like the name "Ivory Soap." I always feel relieved when I see "patents and good will" carried on the balance sheet at one dollar.

**Bonds.**—What is the ratio of this figure to other liabilities and to net worth? Other things being equal, the bond account should be kept relatively low—some authorities say not more than 25 per cent of net worth, plus bonds, combined. In this case the ratio is 43 per cent. Looks a little high, gentlemen.

**Reserves for contingencies.**—This is like a rockslide in the middle of the road. Put on the brakes and stop dead! What are the contingencies? The careful balance sheet reader must investigate what the reserves apply to. Are they for inventories? A reserve here seems reasonable enough in years of creeping inflation. But perhaps some earnings have been covered up in this account, and more explanation is in order. What do the outside auditors say about it?

**Surplus.**—This is apparently an unfortunate name, though it has been standard accounting practice for many years. To George and to many people, and especially to employees, it sounds like free cash set aside in the sock ready for instant use. The worker may see it as an excellent reason for higher wages. Why should he not share in this nice kitty?

In reality, the account usually means earnings plowed back into the business and long since transformed into concrete walls, turret lathes, accounts receivable or inventory items. The "surplus" is all over the lot on the assets side, and normally

you could not take it out in cash without wrecking the business. Furthermore, if the assets had *not* been built up by plowing back earnings, they would have had to come in the form of more bank loans or more bonds issued, and so would have undermined the company's financial health. Every time "surplus" appears on the balance sheet it is a good idea to bear in mind the thought: "earnings, reinvested in the business"—if this represents the facts, as it usually does. Some companies have dropped the term "surplus" altogether and use "earnings reinvested in business" in their annual reports.

### Summing Up

We have set forth the ten questions that many people would like to have answered in an annual report. We have had a good hard look at the income statement and the balance sheet, at least in the upper layers. We have tried to keep things clear and simple, but we have *not* taken any liberties with the fundamental principles of double-entry bookkeeping. If these principles are not scrupulously maintained on the annual report, it would be better to skip the whole thing and curl up with a good book.

If the above analysis is not enough to tell a good company from a sour one, an enterprising management from a sleepy one, an attractive investment from a risky one—then something is wrong with the figures. But nowadays we know that because of the double-entry systems, the CPA audit, the requirements of the Securities and Exchange Commission and the income tax examiners, figures are not easy to juggle.

Annual reports can often be improved, particularly if their authors keep George and his 20 shares of stock firmly in mind. But never since corporations were invented have annual reports been closer to the facts than they are today.

[The End]